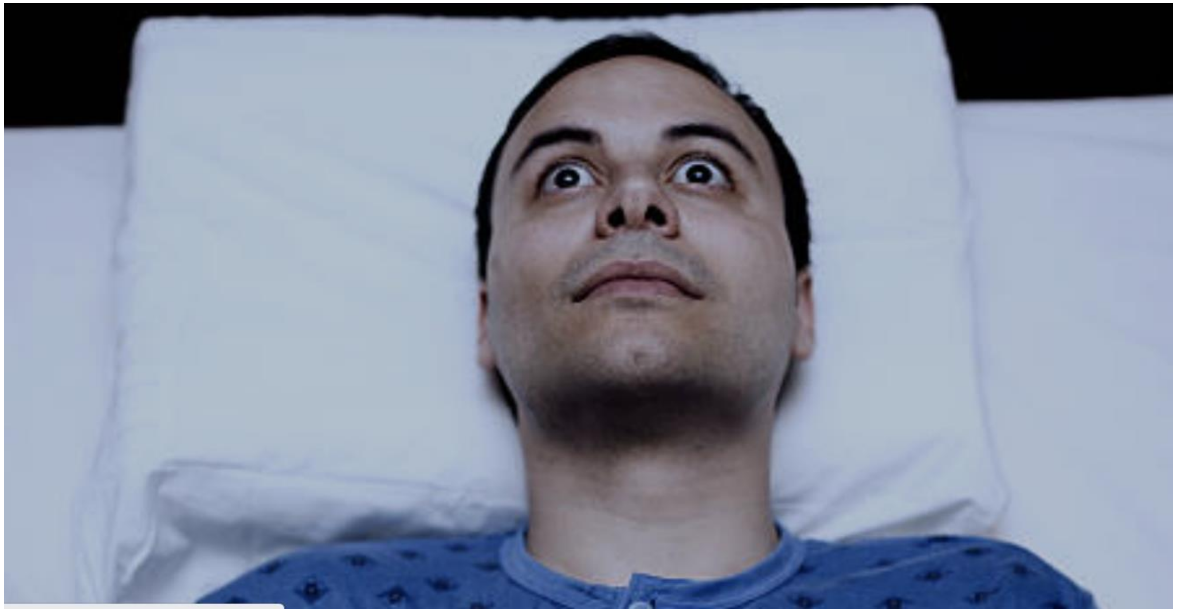
Absolute Return Partners



ARP Webinar

A few conundrums that keep me awake at night

29th March 2023

Agenda

Part 1 – Conundrum #1

China – an outstanding investment case or not?

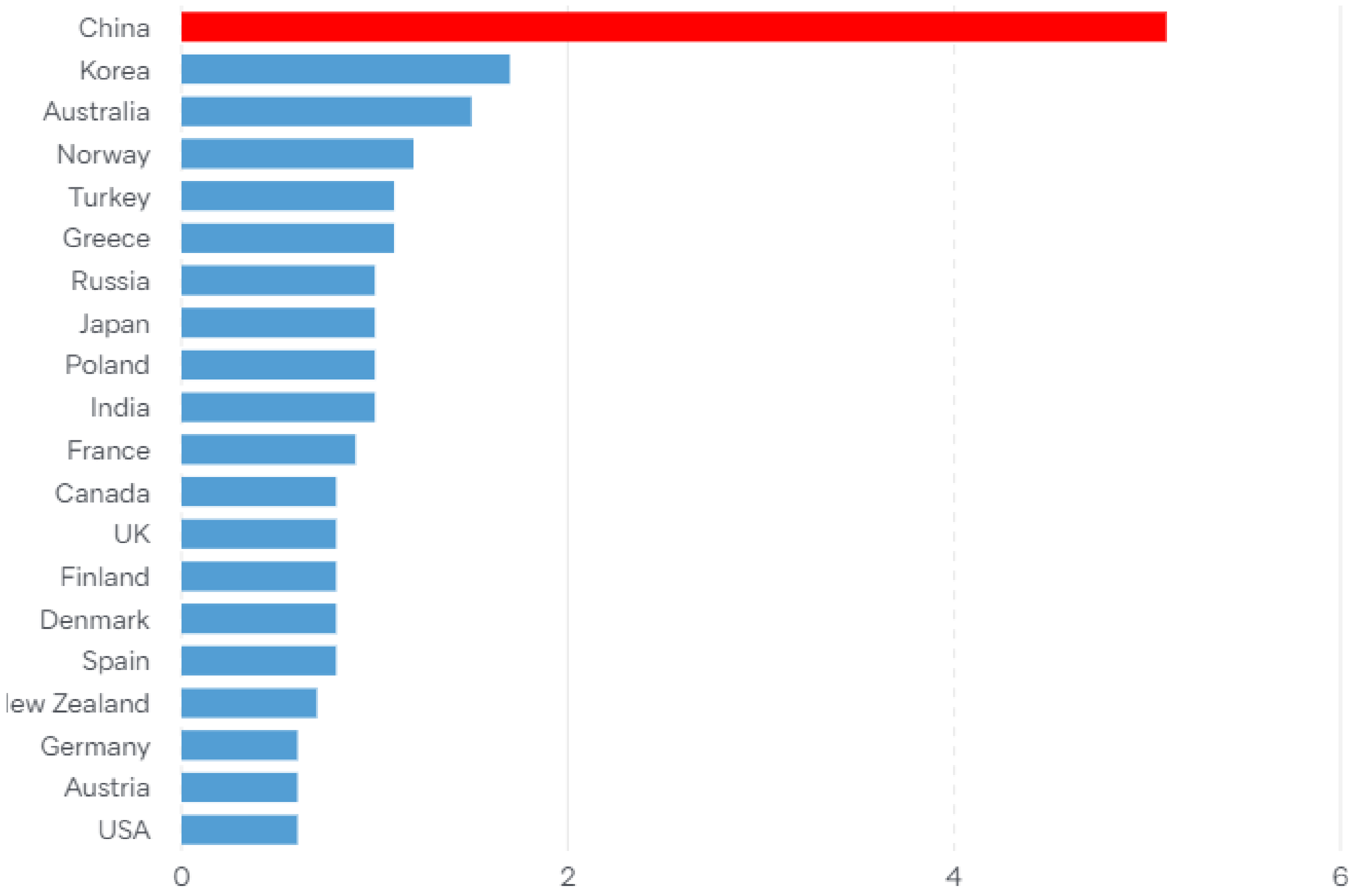
The Chinese, on average, are more proficient at utilizing new IT services compared to the average Indian, which is likely to stimulate Chinese GDP growth.

Access to Various IT Services – China vs. India

	CHN total	CHN per 1000 inh.	IND total	IND per 1000 inh.
Landlines:	180,700,500	128	23,773,751	17
Mobile cellulars:	1,732,661,400	1227	1,154,046,584	820
Internet server:	20,602,000	15	6,746,000	5
Internet users:	1,031,774,760	731	605,252,452	430
Broadband Internet:	535,786,000	379	27,560,000	20

Chinese GDP has indeed grown fast in recent years, driven by massive infrastructure investments more than anything else.

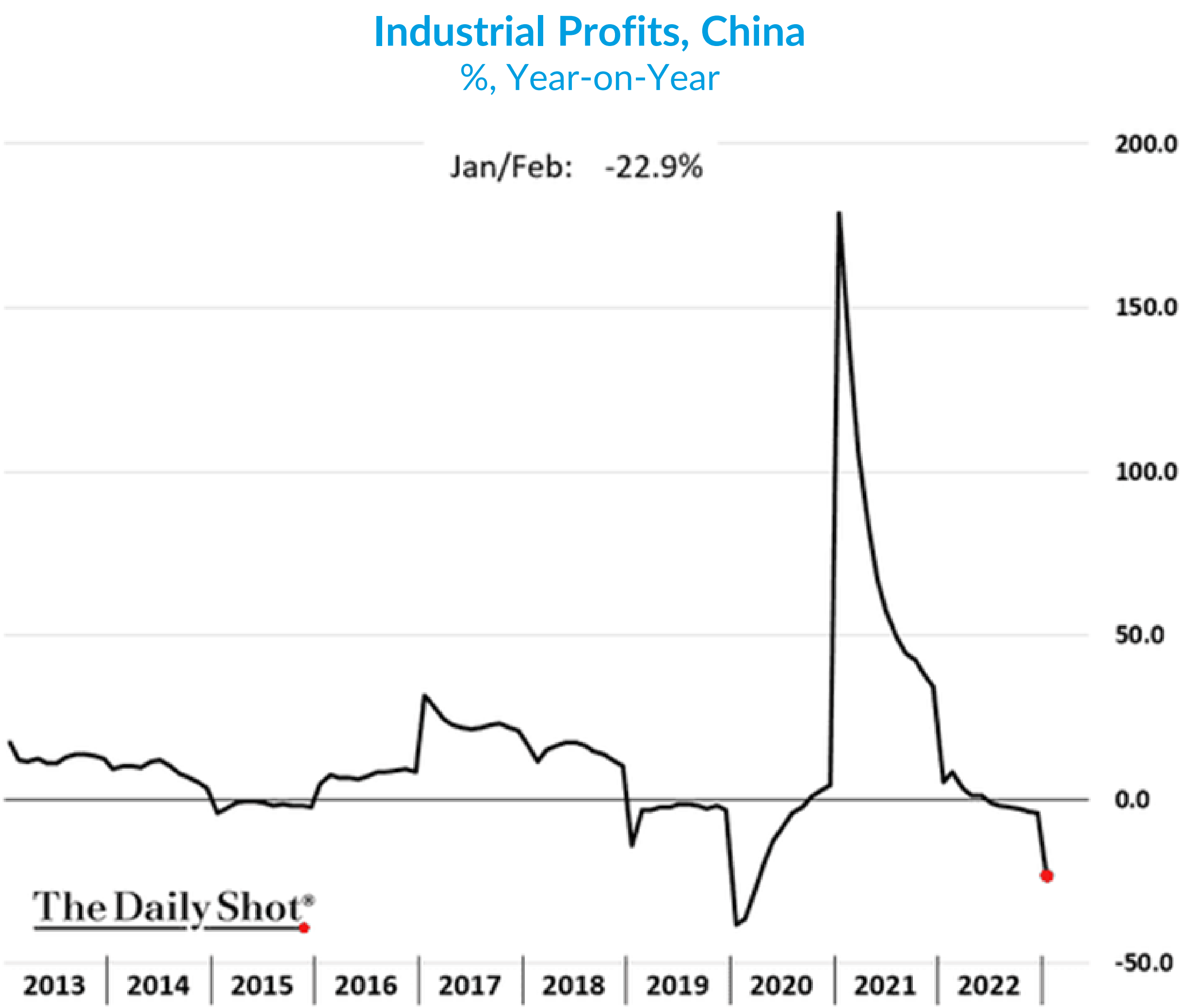
Total Inland Transport Investments – Various Countries
% of GDP, 2010-19 Average



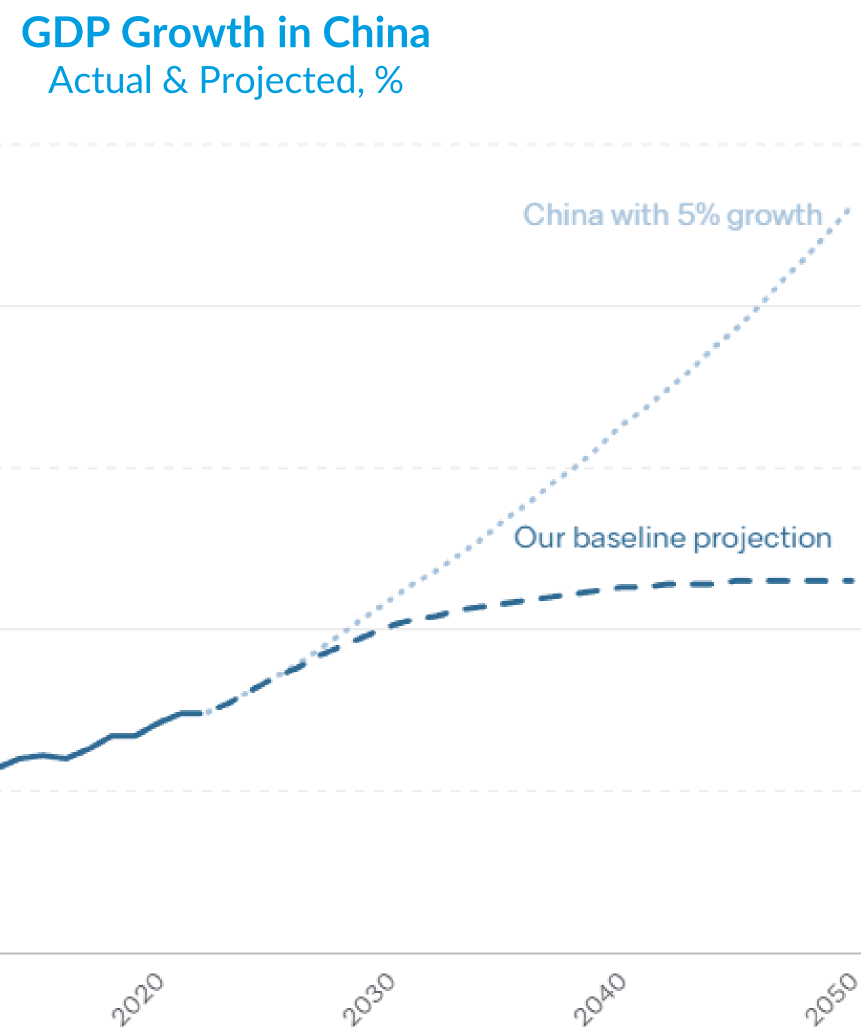
Despite China being one of the fastest growing economies worldwide, there is a problem. Money is flowing out of China's financial markets in unprecedented numbers. Why?

Daily Equity Flows into and out of China a.o. EM
$ Millions

Short-term concerns about corporate profits could very well be one of the reasons.



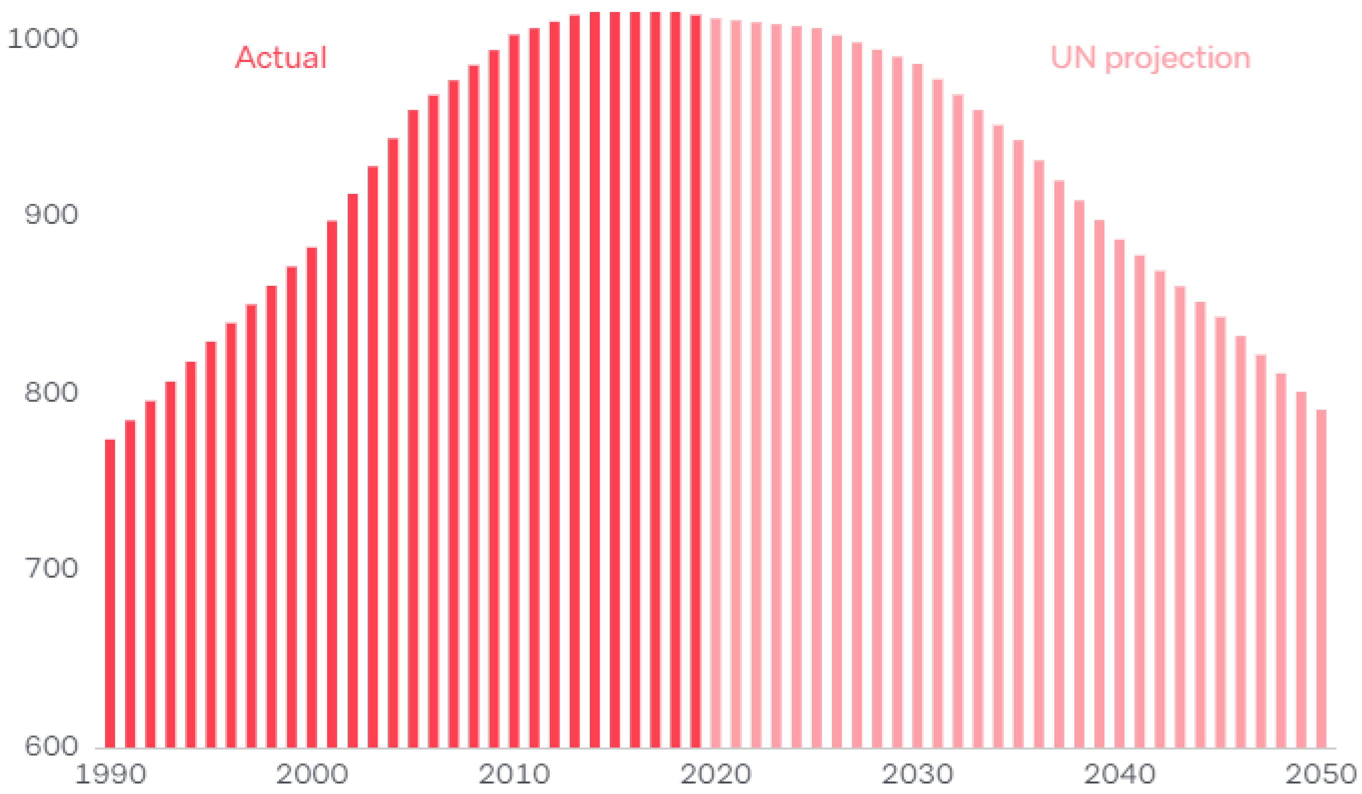
Longer term, the Chinese growth story will change dramatically …



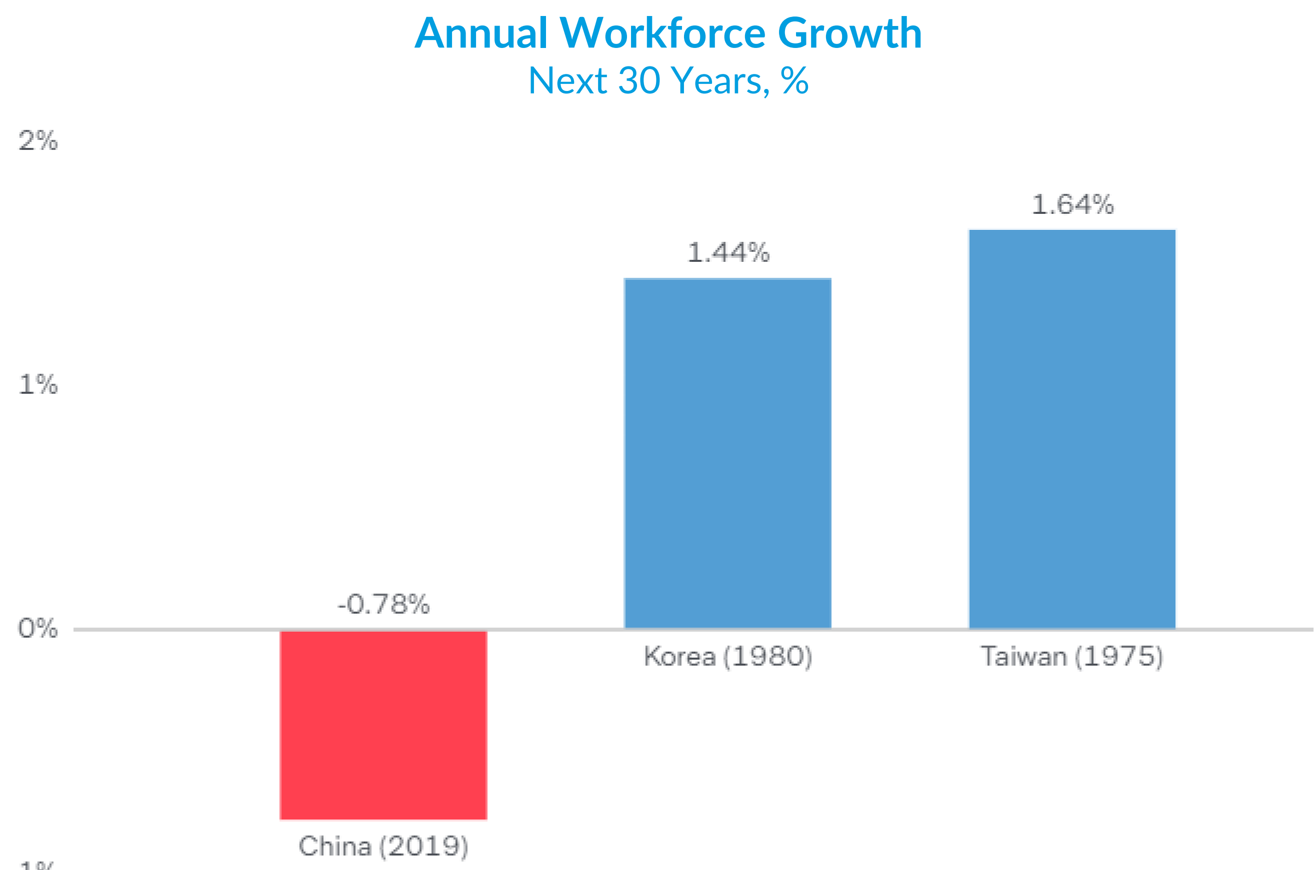
… and the main reason is extraordinarily destructive demographics about to unfold.

China's Working Age Population

Actual & Projected, Millions



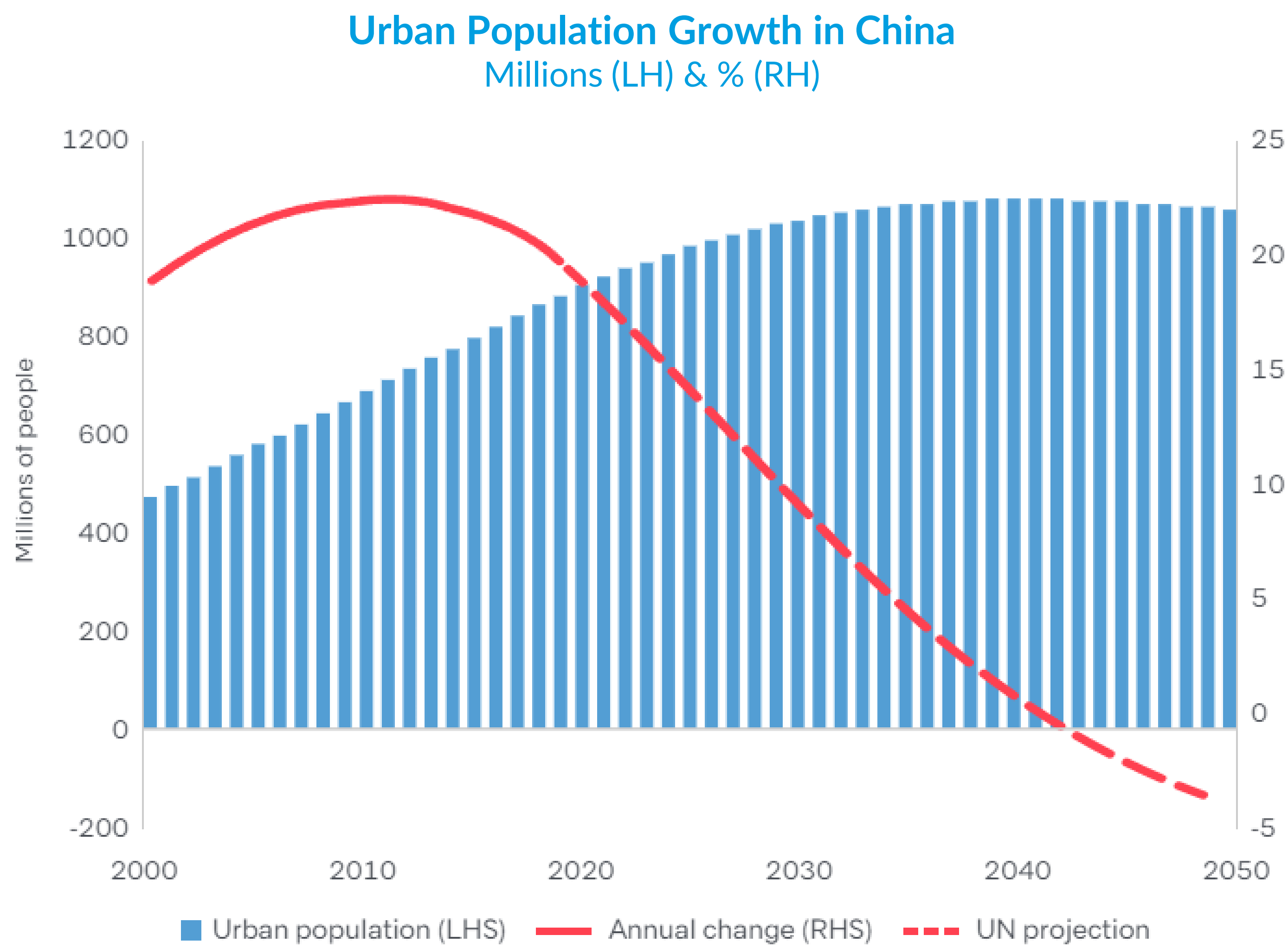
China's demographic outlook contrasts to that of other East Asian economies. Their workforces grew briskly when they began to move up the economic ladder in the 1980s.



Remember this?

$\triangle GDP \approx \triangle Workforce + \triangle Productivity$

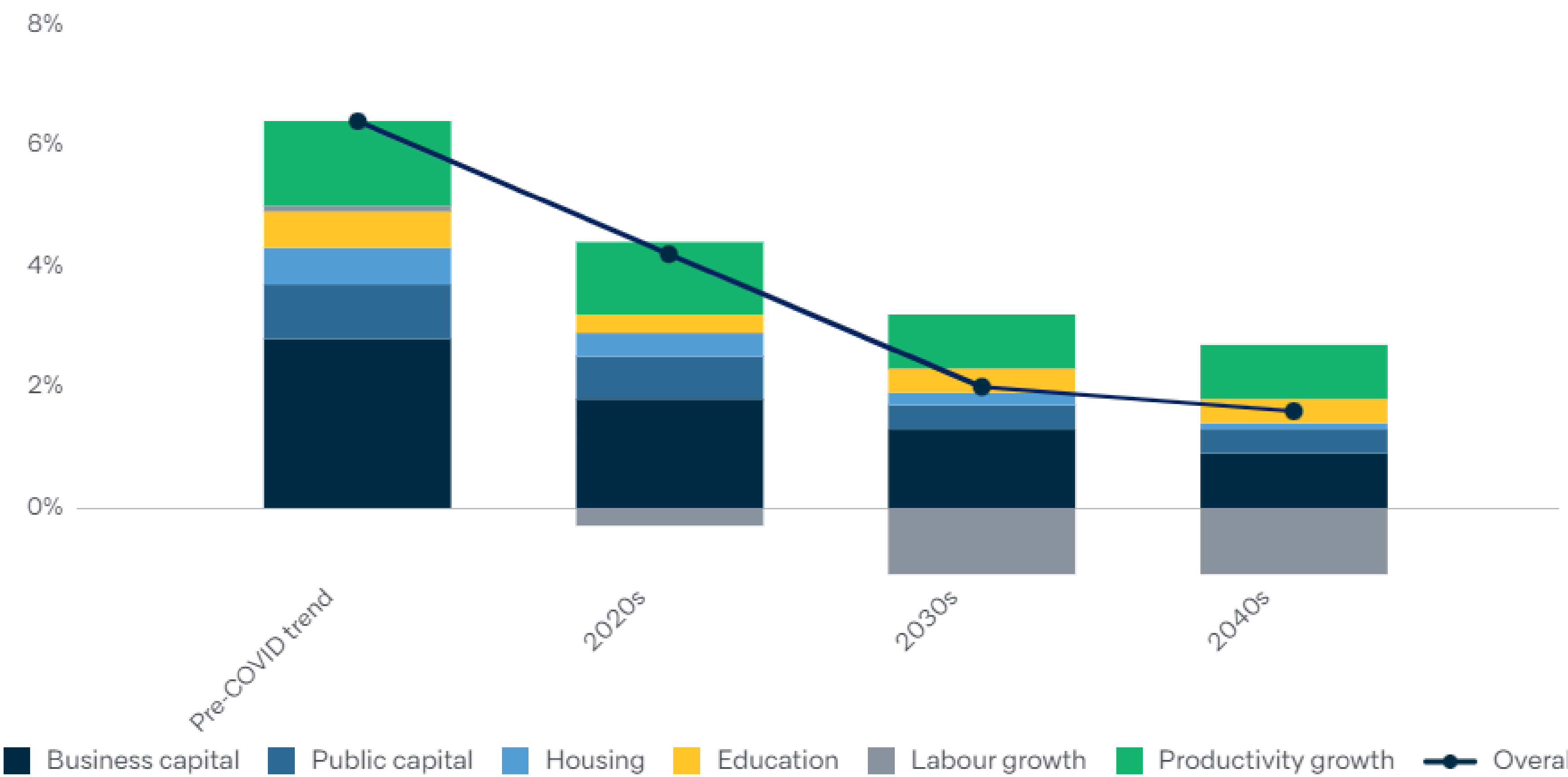
Many argue that domestic migration will compensate for punishing demographics, but urbanisation has also begun to slow.



The bottom line is that GDP growth will slow dramatically and that many investors have unrealistic growth expectations going forward.

China's Sources of Economic Growth

Average Annual % Growth by Source

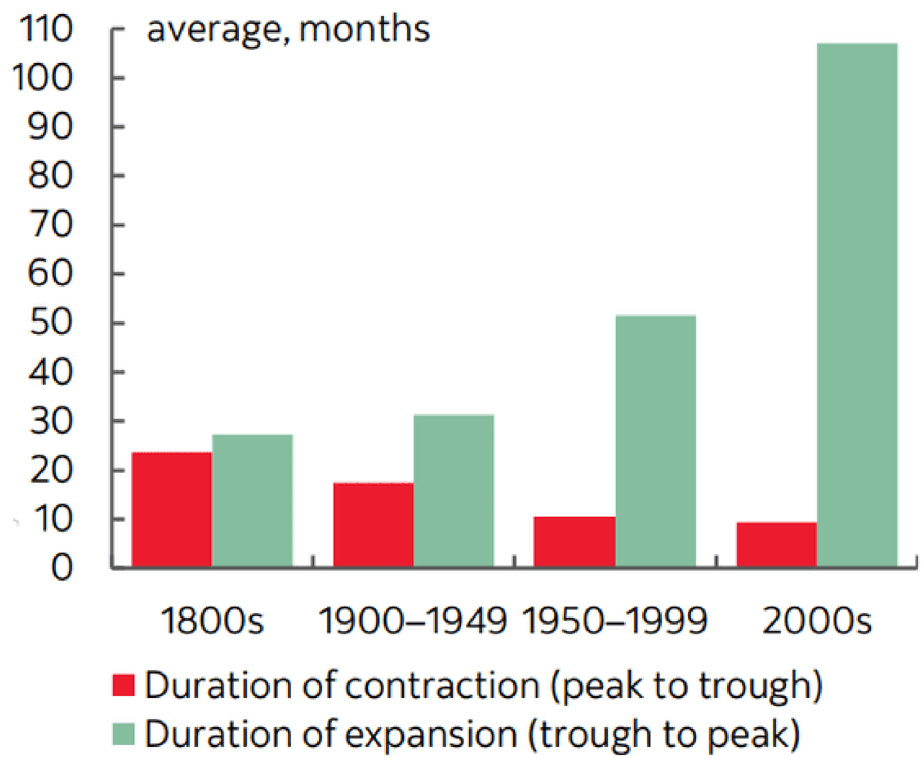


Conundrum #2

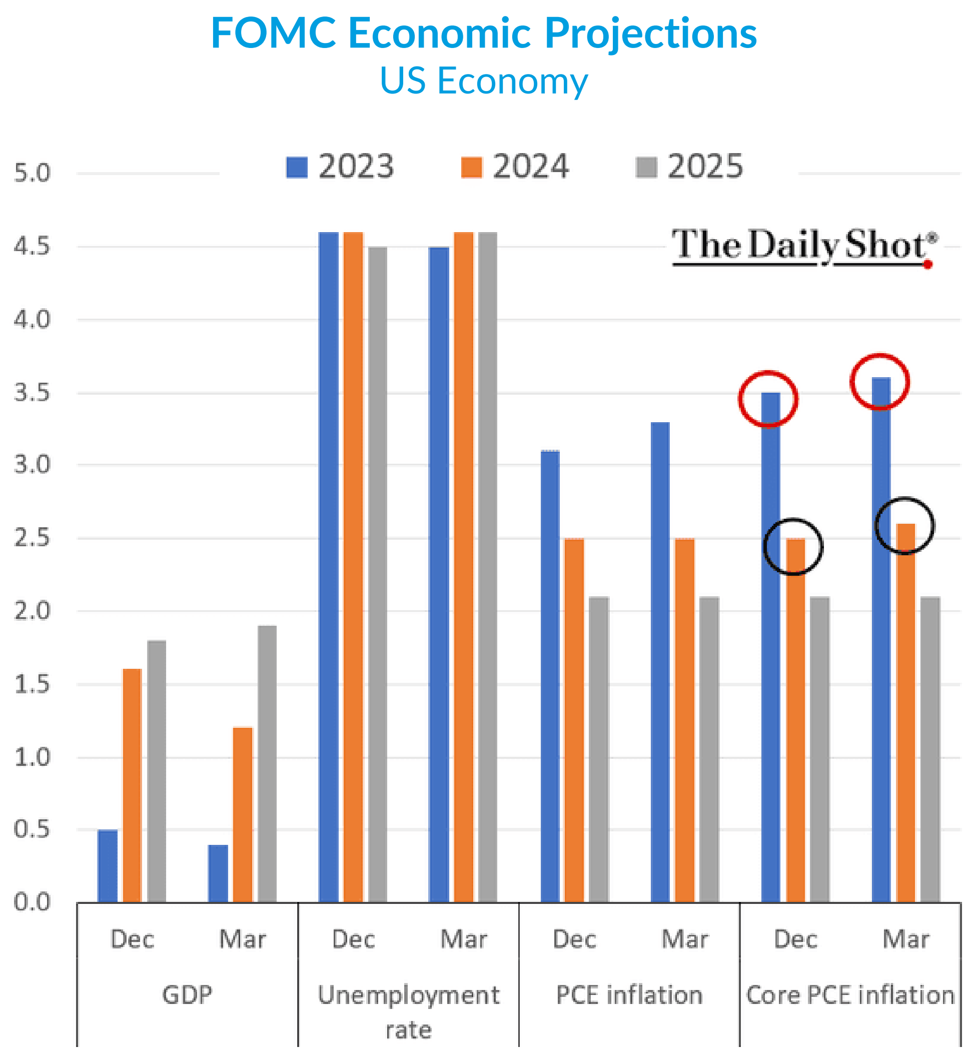
Recession – imminent or not?

The nature of recessions has changed, but one could nevertheless argue that we are due one. The signals are mixed, though.

Average Duration of Recessions & Expansions



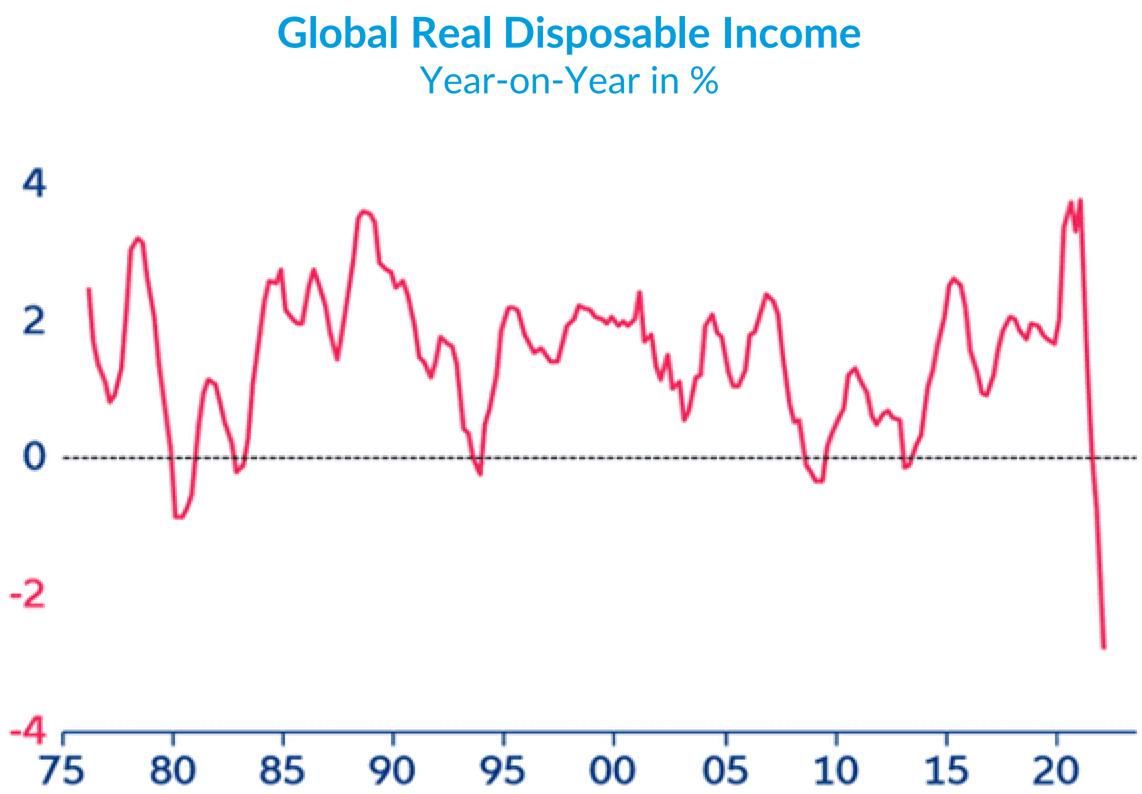
The FOMC doesn't believe a recession is imminent. Slowing economic growth? Yes! Recession? No!



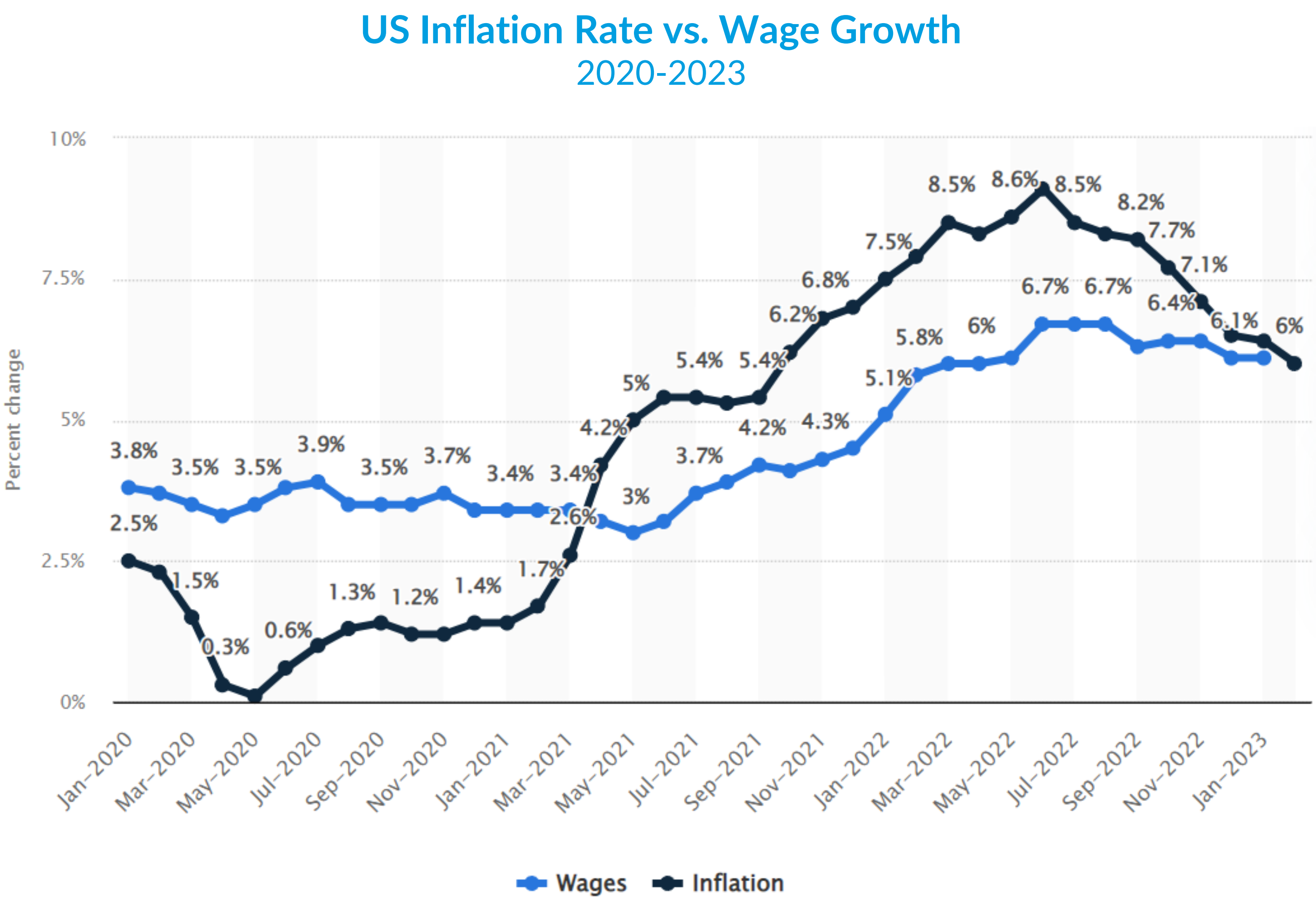
Others are not so sure. A meaningful deterioration of financial conditions in recent weeks has convinced many that a US recession is around the corner.

Bloomberg Financial Conditions Index

Collapsing real household incomes, the primary source of GDP growth, supports the argument that a recession is imminent.

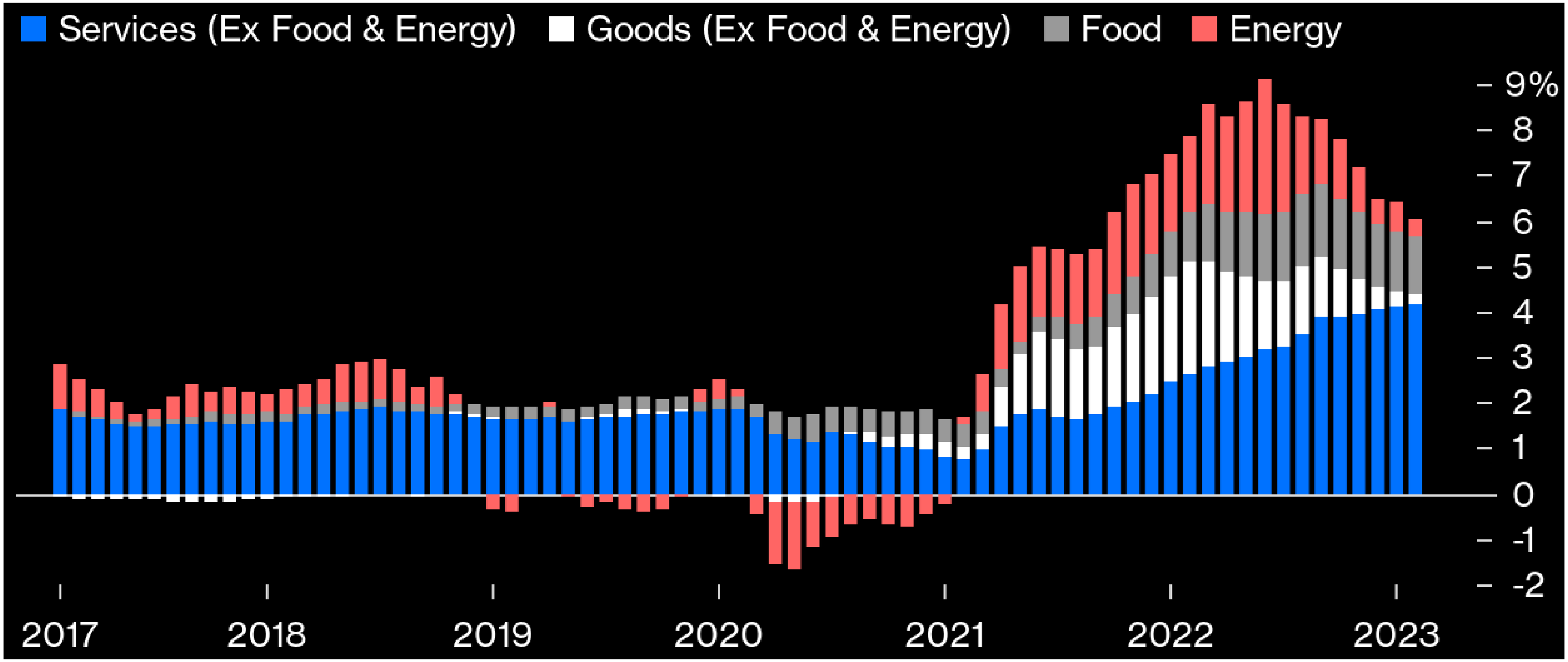


Why have real household incomes collapsed? Because wage growth, despite running at high levels, hasn't matched the rate of inflation the last two years..



Unless wage growth drops significantly, services inflation will remain high, and that will almost certainly force the Fed to hike further.

Components of US Consumer Price Inflation

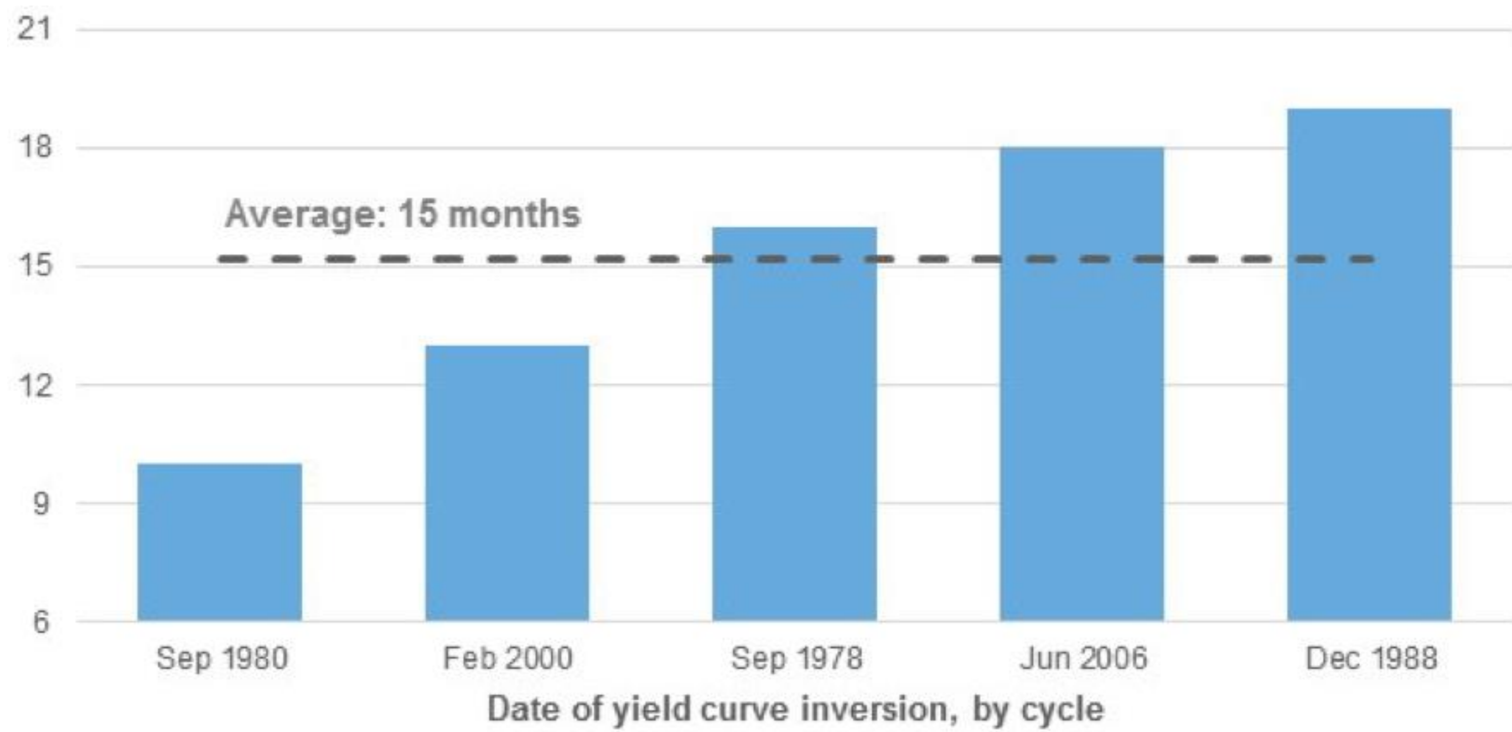


The US yield curve inverted in late 2022 and continues to be inverted. This is a strong signal that the US economy will go into recession.

US Treasury Yield Spread
10-Years Less 3-Months

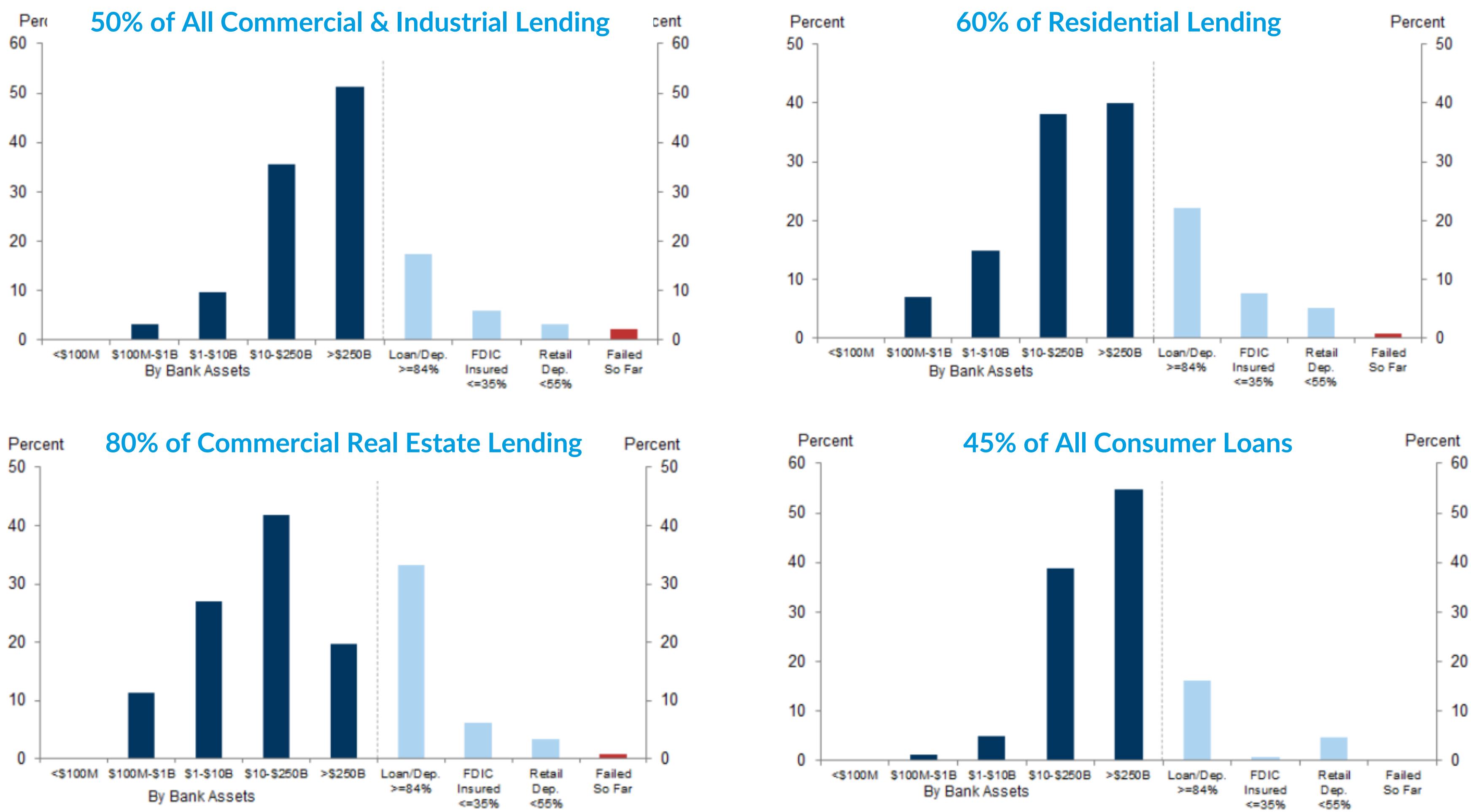
Over the last 50 years, on average, it has taken 15 months from the yield curve inverted until the economy was in full-blown recession.

Time to Recession from Initial Yield Curve Inversion



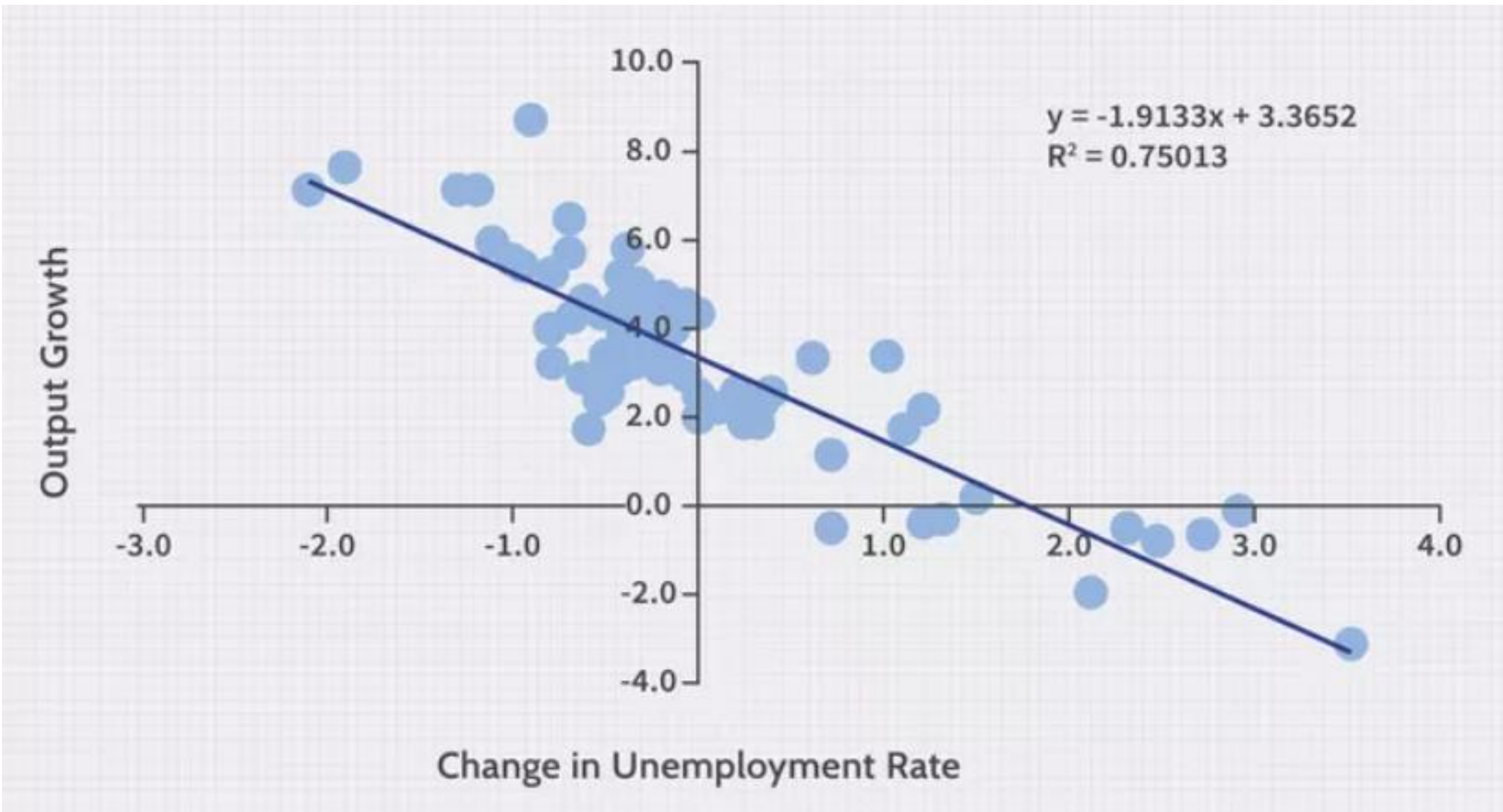
The regional banking crisis has significantly increased the probability of a US recession. Regional banks account for much of the lending activity in the US.

The Share of Total Lending by Small and Medium-Sized Banks



Recessions rarely unfold unless unemployment rises by at least 1% over a 12-month period. Therefore, it is unlikely that a US recession is imminent.

Okun's Law



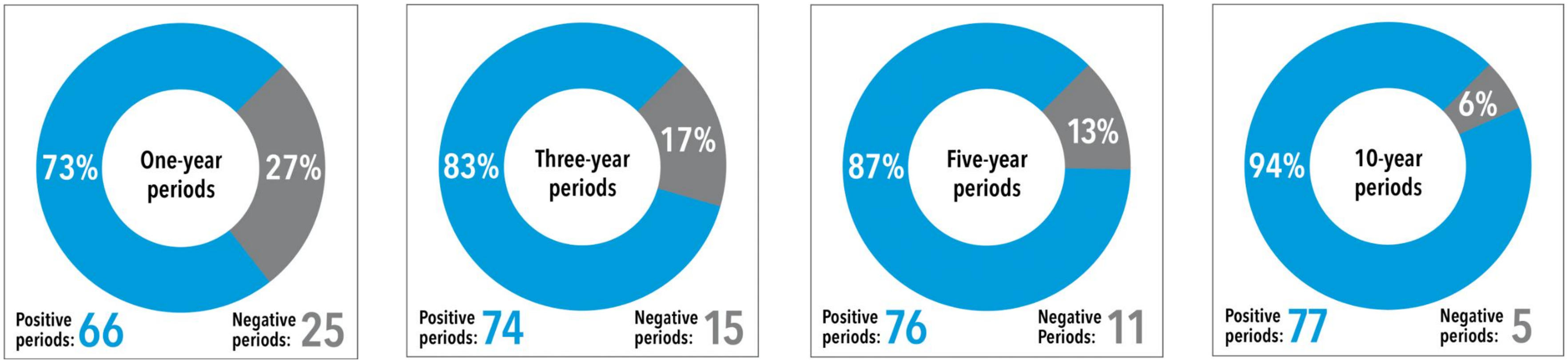
Conundrum #3

Investment approach – always fully invested or not?

There are powerful arguments in favour of always being fully invested.

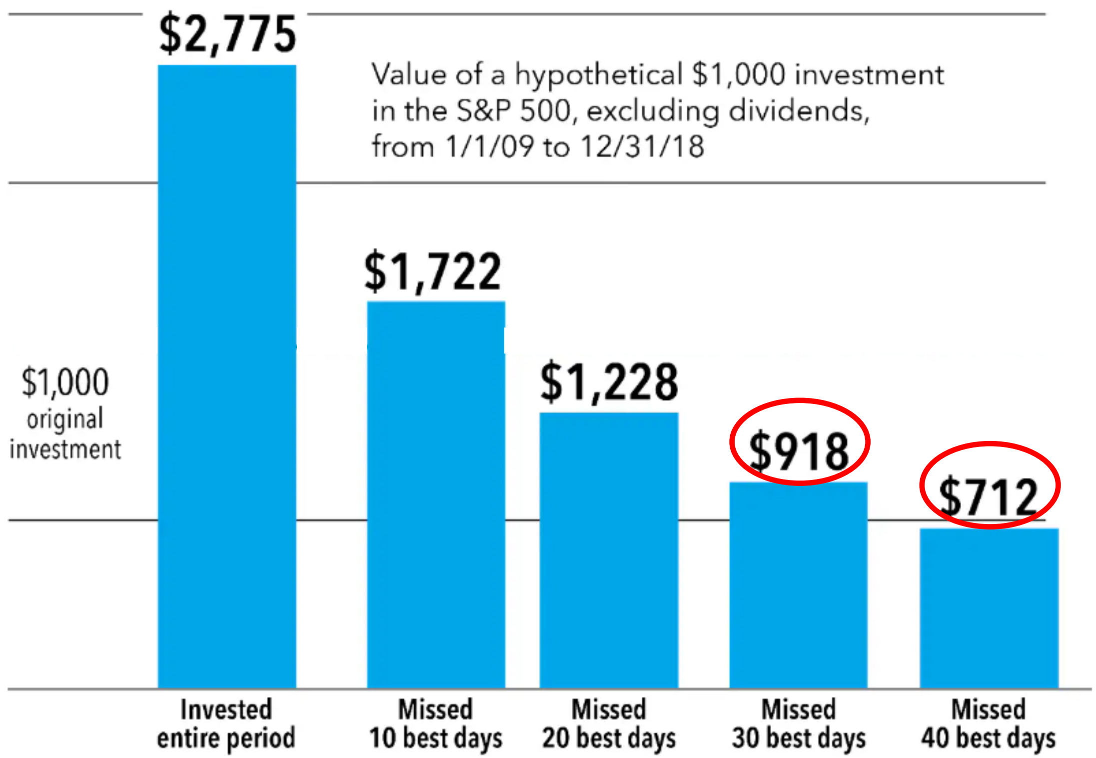
Total Return of the S&P 500 over Various Periods

91 Years between 1928 and 2018



The argument can be taken even further by maintaining that you may end up with negative returns unless you are always fully invested.

Value of $1,000 Invested in S&P 500 between 01/01/2009 and 31/12/2018



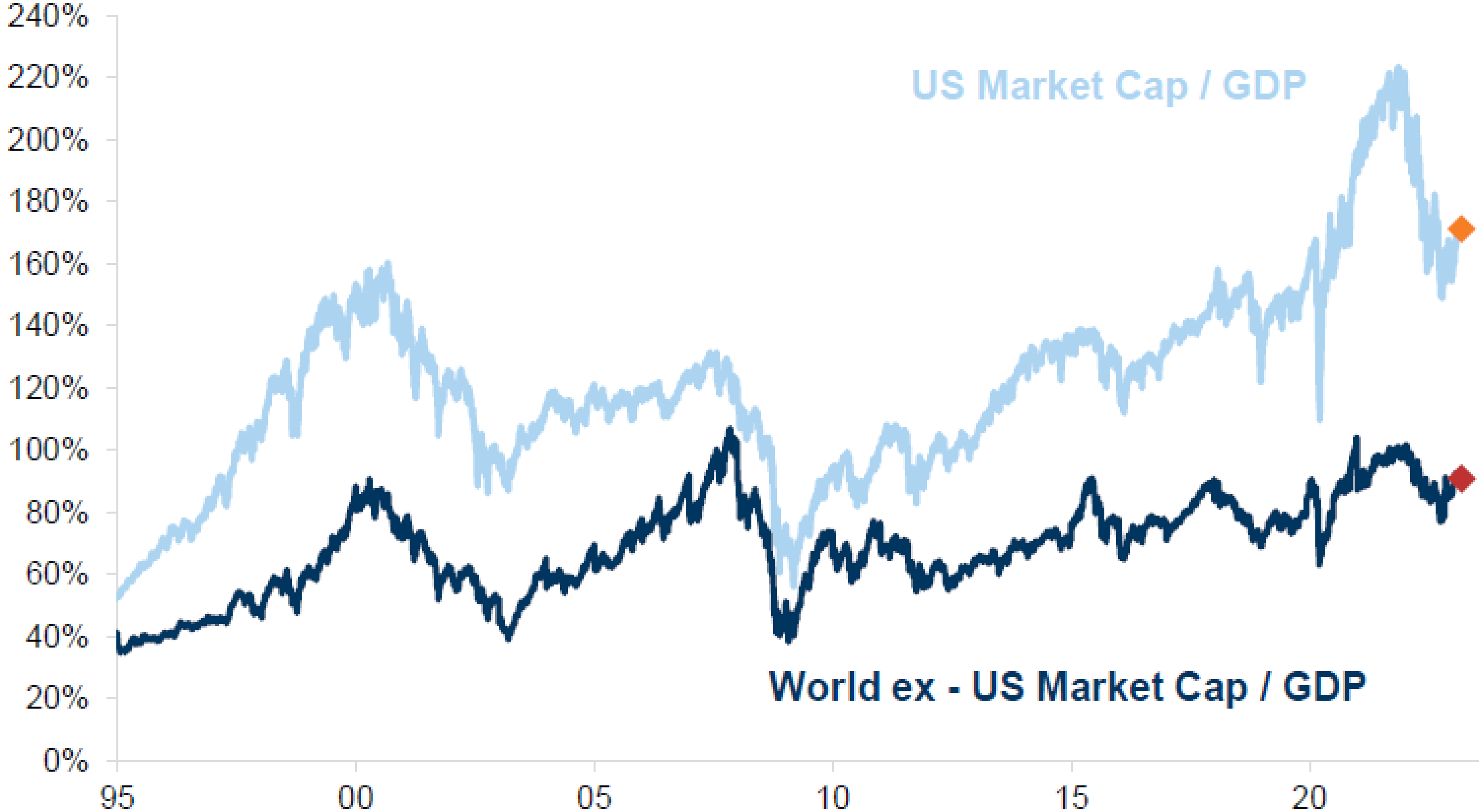
I have two problems with that argument. Firstly, the calculations on the previous slide are based on a 10-year period with few significant drawdowns.

S&P 500 since 1928

Secondly, US equities are excessively valued at present when compared to equities in other parts of the world.

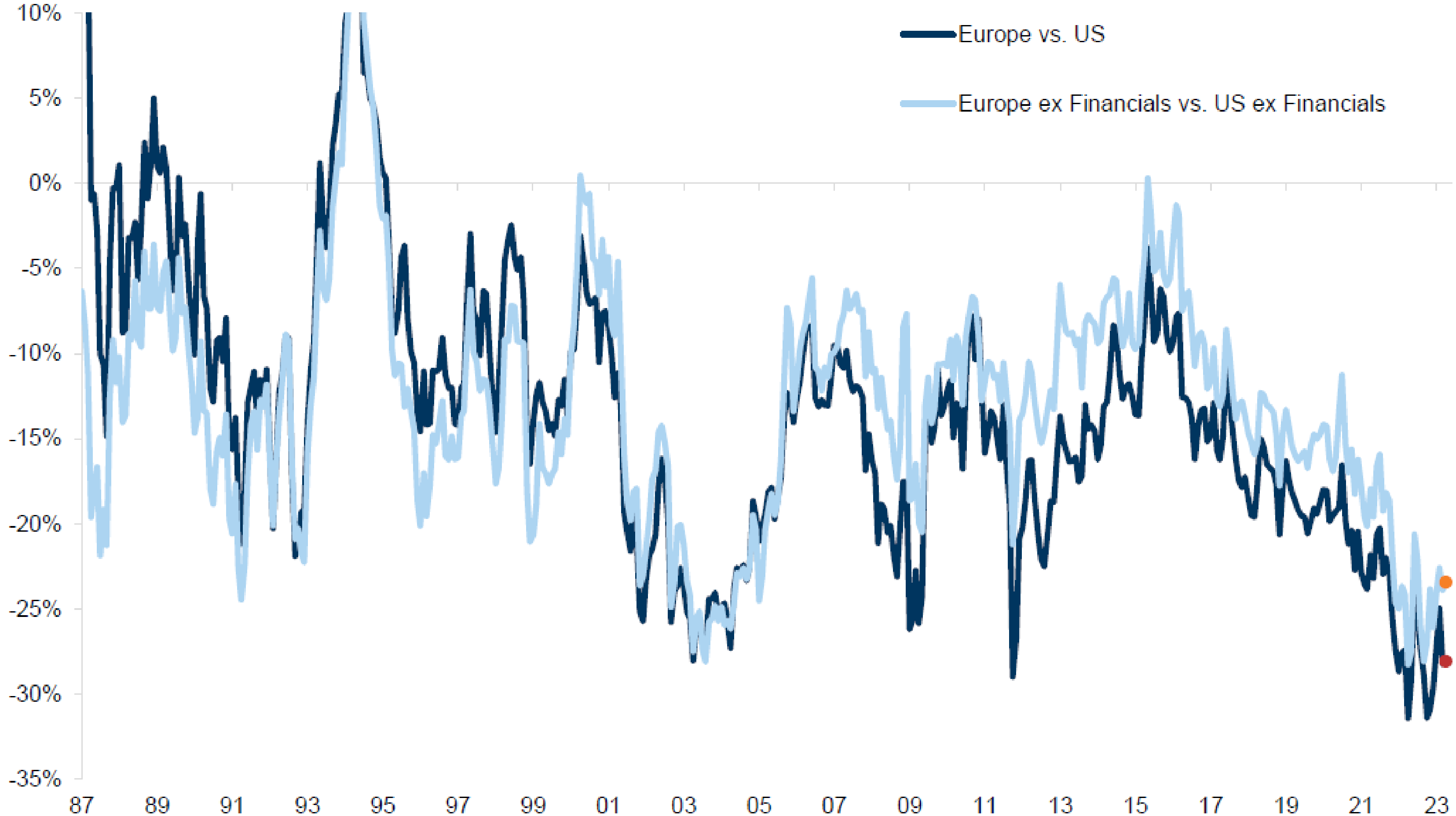
Market Cap-to-GDP

The US vs. World ex. US, %



Japanese and European equities are both priced attractively. European equities trade at a valuation discount of 25-30% compared to US equities …

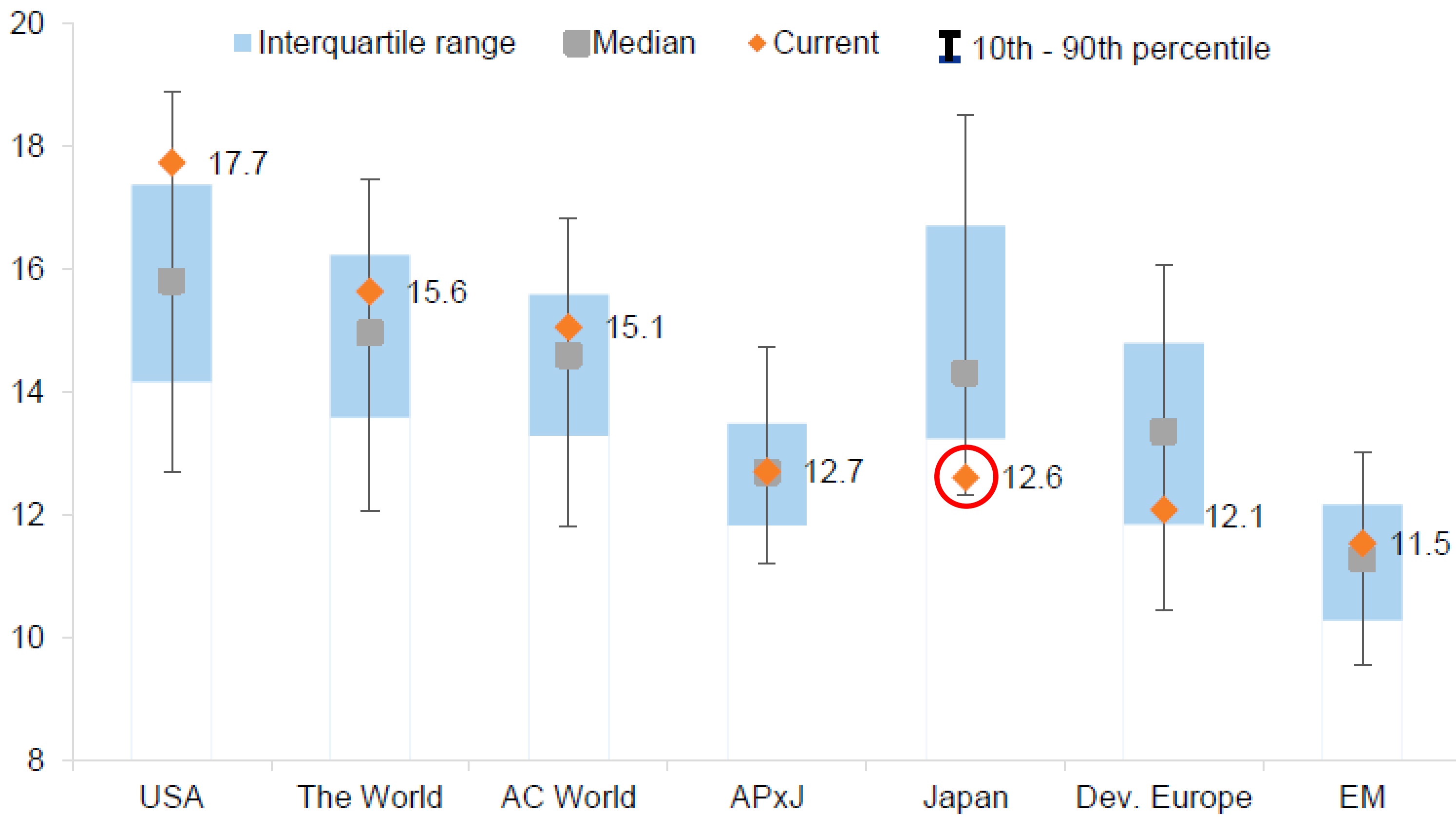
Europe vs. US 12-Month Forward P/E Premium/Discount



… and Japanese equities trade near the bottom of its 10-year valuation range. Despite that, don't expect RoW to de-couple in a US-led correction.

12-Month Forward P/E Valuation Ranges over a 10-Year Timeline

MSCI Countries & Regions



Part 4

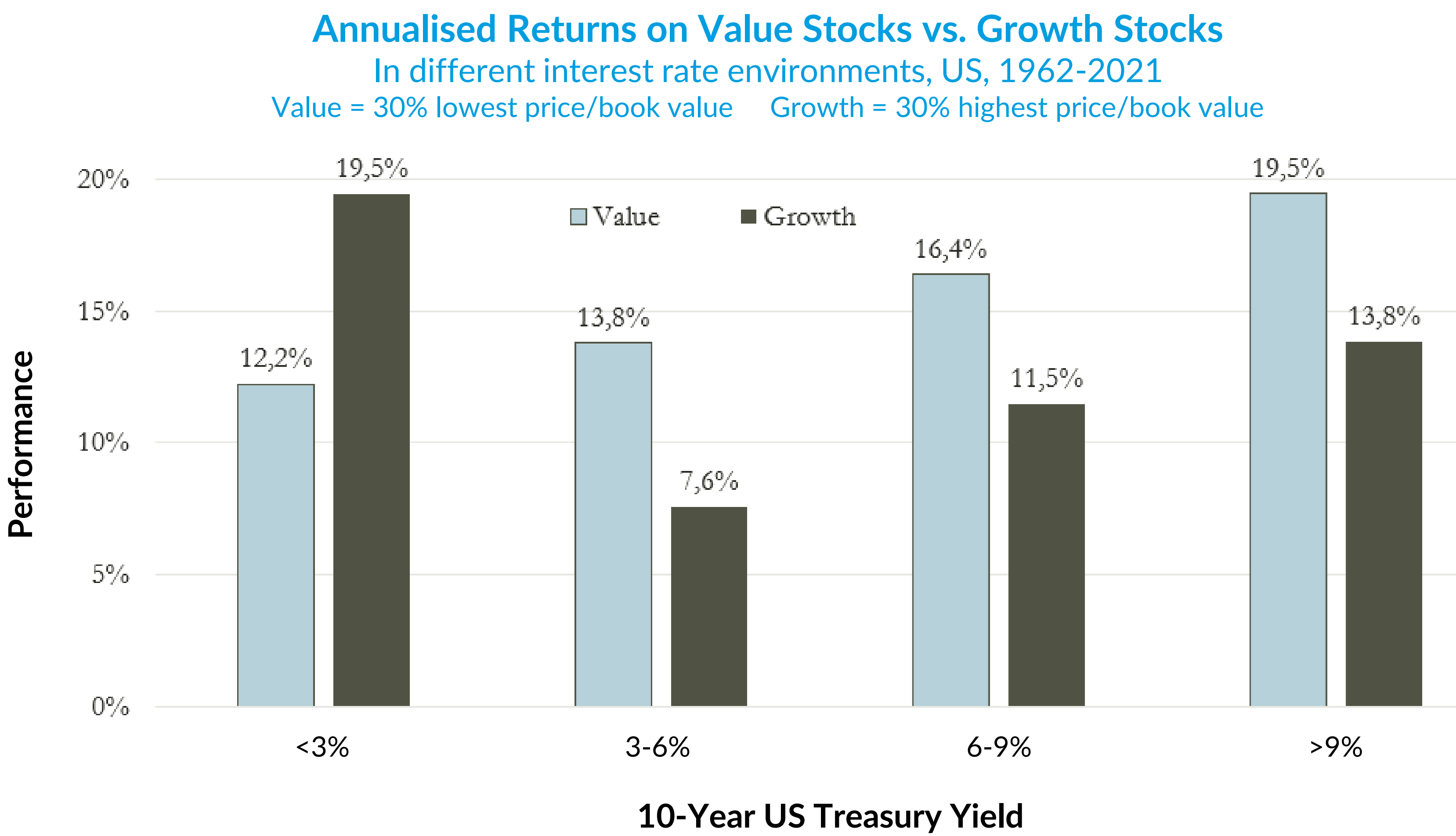
Key takeaways & Investment implications

The takeaways so far.

1. China is a basket case. Despite being at the forefront in many respects, poor demographics will almost certainly result in economic growth slowing dramatically in the years to come. As a consequence, we favour exposure to **Rise of the East** through other Asian markets.
2. Despite the US labour market being very robust at present, the signs are ominious that a US recession is not far away. Therefore, we continue to recommend that you keep the equity beta in your portfolio relatively low.
3. Despite the argument in favour of remaining fully invested at all times, we don't think it is the right strategy going into a recession.

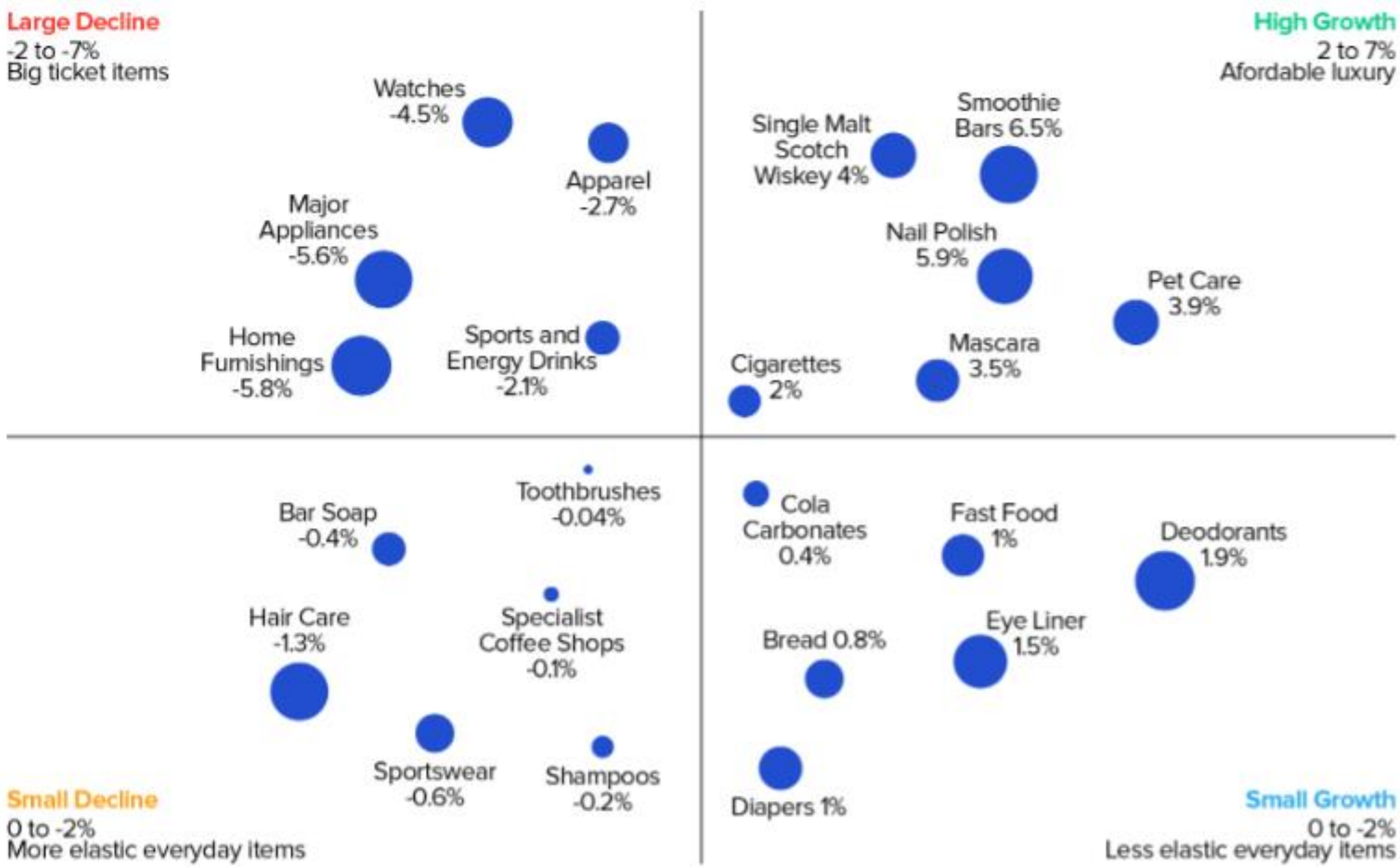
So, what should you do?

#1: Over the last 60 years, value has outperformed growth, when 10-year Treasuries have yielded more than 3%. They currently yield 3.56%. **OVERWEIGHT VALUE STOCKS.**



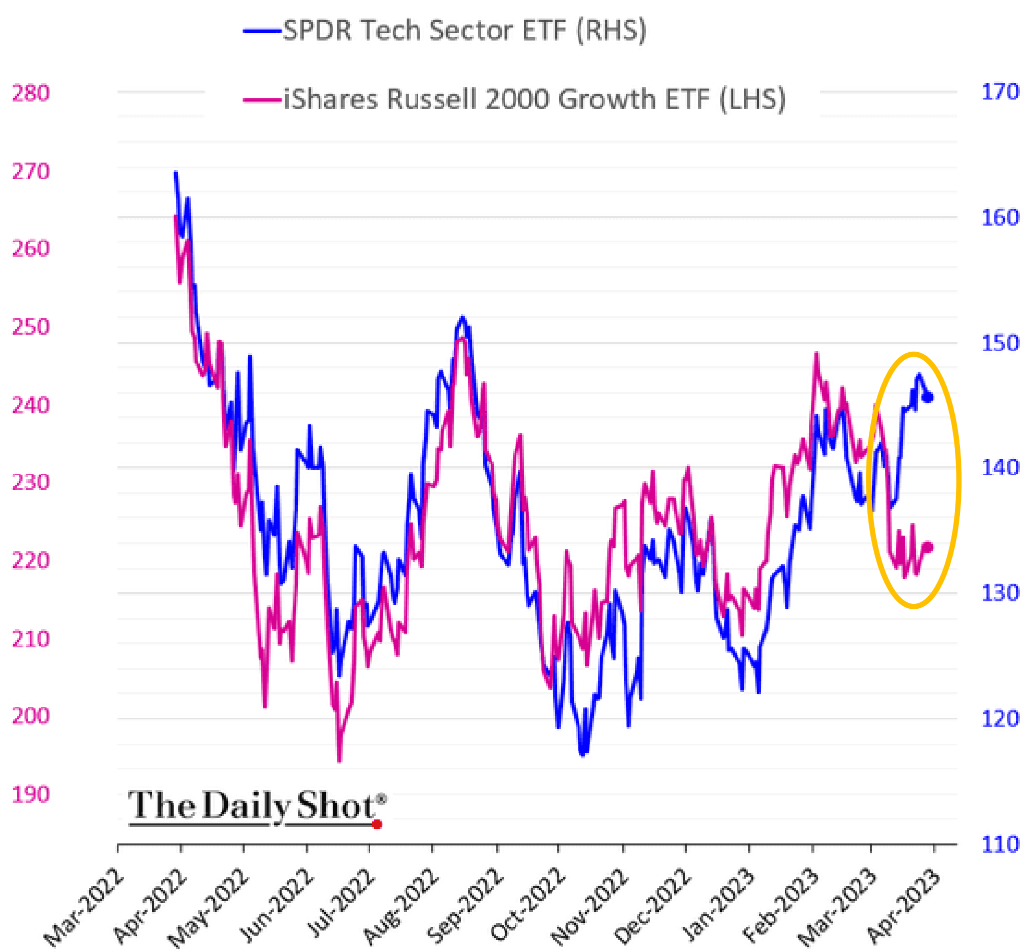
#2: Some sectors are more recession-resistant than others. **REBALANCE YOUR PORTFOLIO IN FAVOUR OF RECESSION-RESISTANT INDUSTRIES.**

Performance of Various Company Types during the GFC in 2008-09



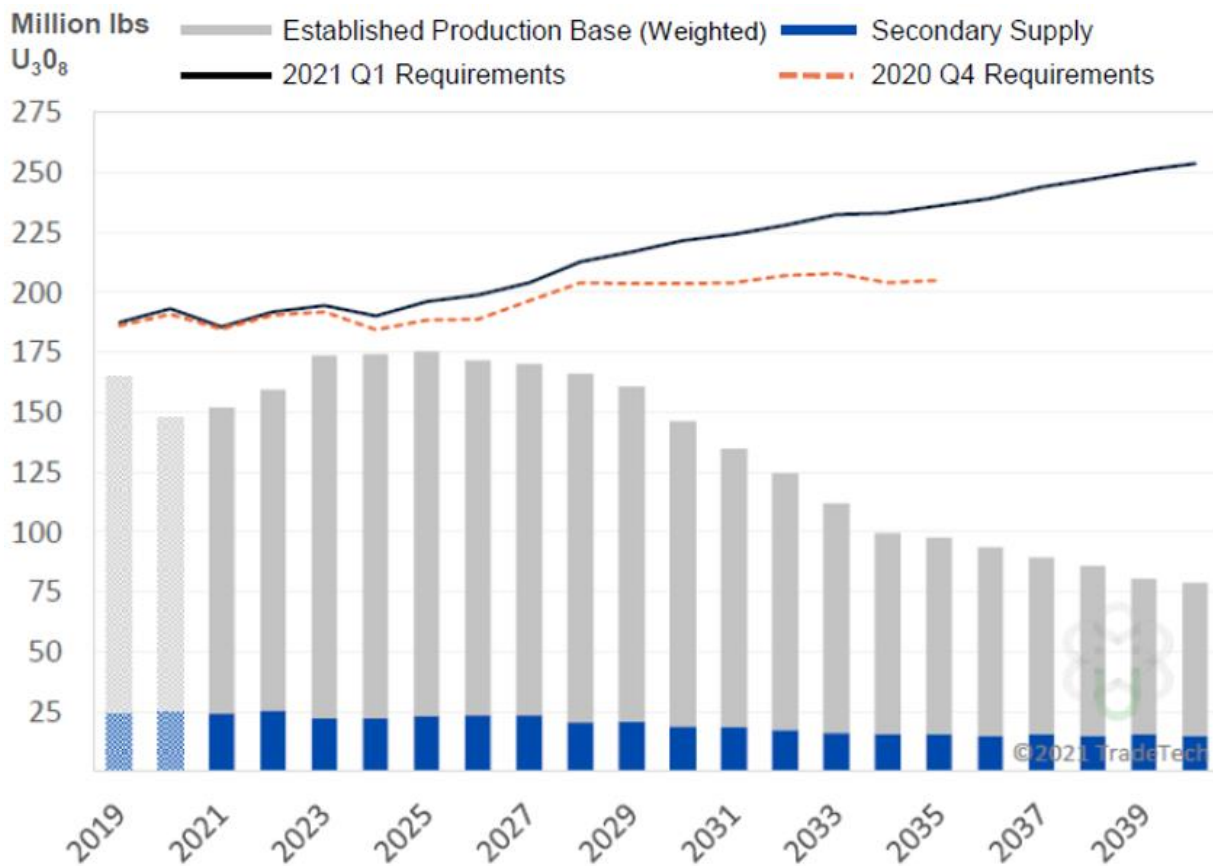
#3: If inflation has peaked and we are due a recession, long-dated bond yields will decline. **INCREASE YOUR EXPOSURE TO LONG-DURATION ASSETS.**

Small-Cap Growth vs. Large Cap Tech



#4: As policy makers come to realise that fossil fuels *cannot* be phased out without embracing nuclear energy, uranium stocks should appreciate. **GO LONG URANIUM.**

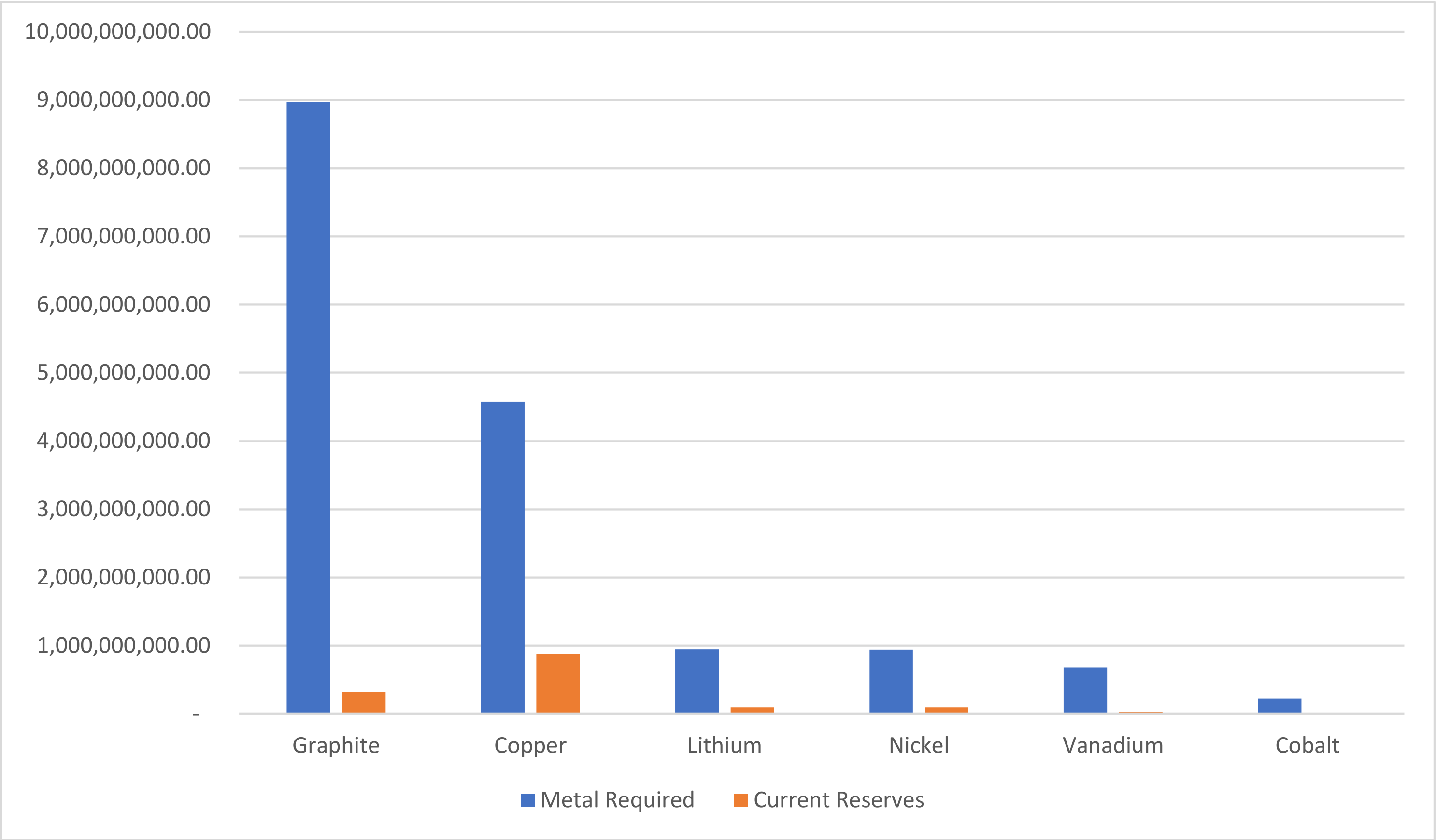
Uranium Supply and Demand, Worldwide



#5: A handful of green metals required to go 100% green do not exist in sufficient quantities. **GO LONG CERTAIN GREEN METALS.**

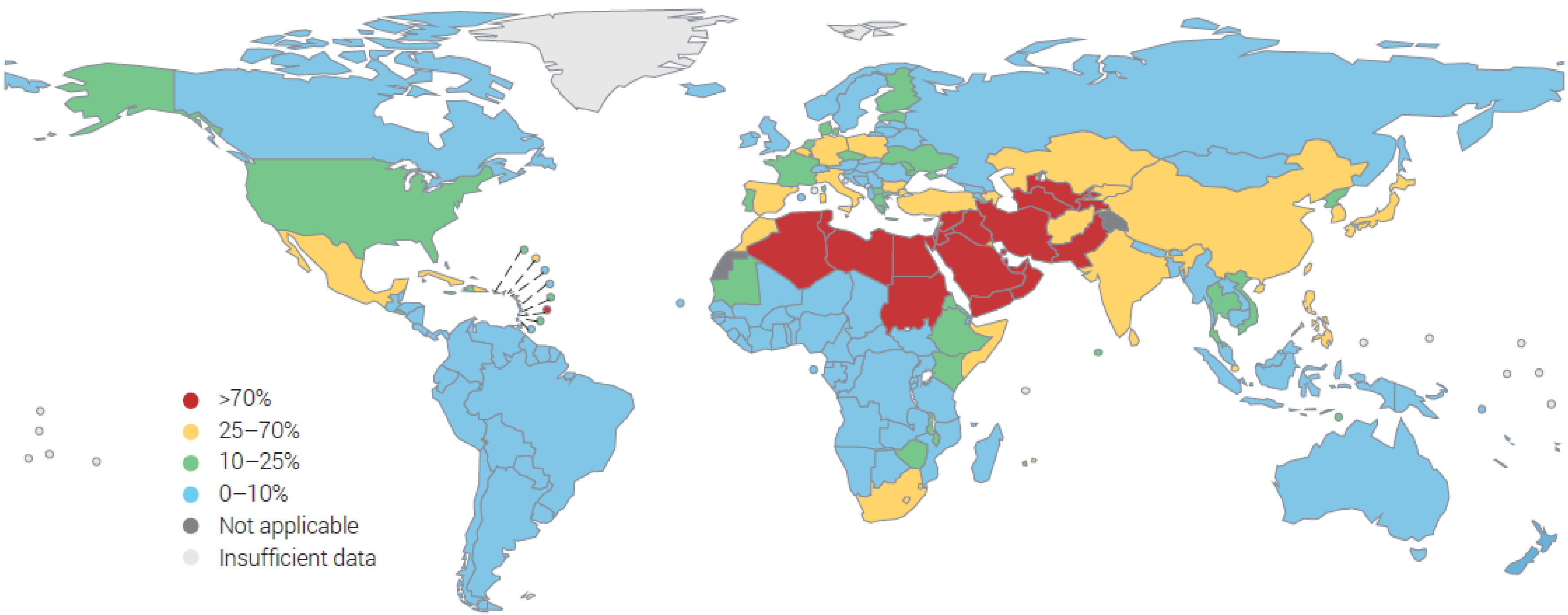
Amount Needed for First Generation Renewable Infrastructure vs. Proven Reserves

Tonnes



#6: Over the past 40 years, the world's population has doubled, whereas water consumption has quadrupled. This spells trouble. **GO LONG WATER TECH.**

Level of Physical Water Stress



*Physical water stress is defined here as the ratio of total freshwater withdrawn annually by all major sectors, including environmental water requirements, to the total amount of renewable freshwater resources, expressed as a percentage.

Appendix

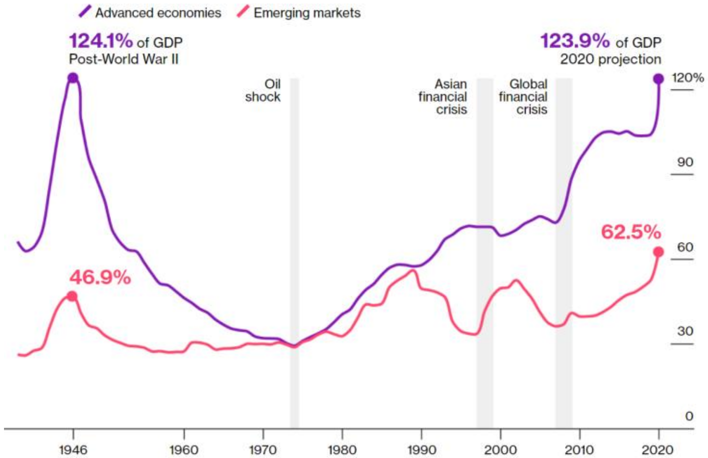
The seven megatrends

Megatrend #1

Last Stages of the Debt Supercycle

- In the early stages of all previous debt supercycles, debt and GDP have grown approx. 1:1, but that ratio has deteriorated as the cycle has matured. All prior debt supercycles have come to an end when GDP has grown only $0.20-0.25 for every dollar of added debt.
- The fact that △GDP is struggling to gain momentum is a powerful indication that we are fast approaching the end of the current debt supercycle. China's △GDP/△Debt ratio is now 0.21, whereas it is 0.28 in the US.
- The pandemic has driven global government indebtedness to the highs of previous debt supercycle and has moved the end of this supercycle closer.

Total Govt. Debt:
(% of GDP)

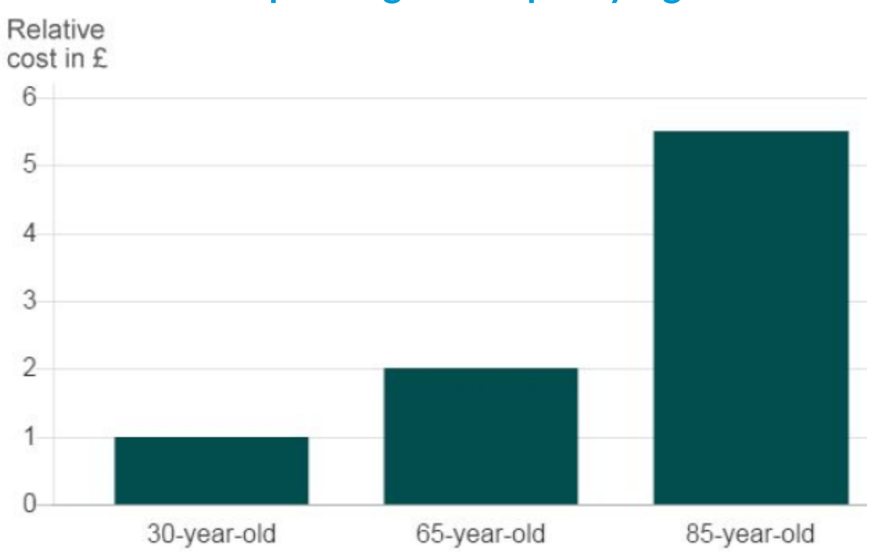


Megatrend #2

Changing Demographics

- 150 million OECD workers will retire between now and 2050.
- Servicing the elderly is extremely costly. According to the NHS, servicing a man in his mid-80s is 5-6 times more expensive than servicing a man at the age of 30.

NHS Spending on People by Age

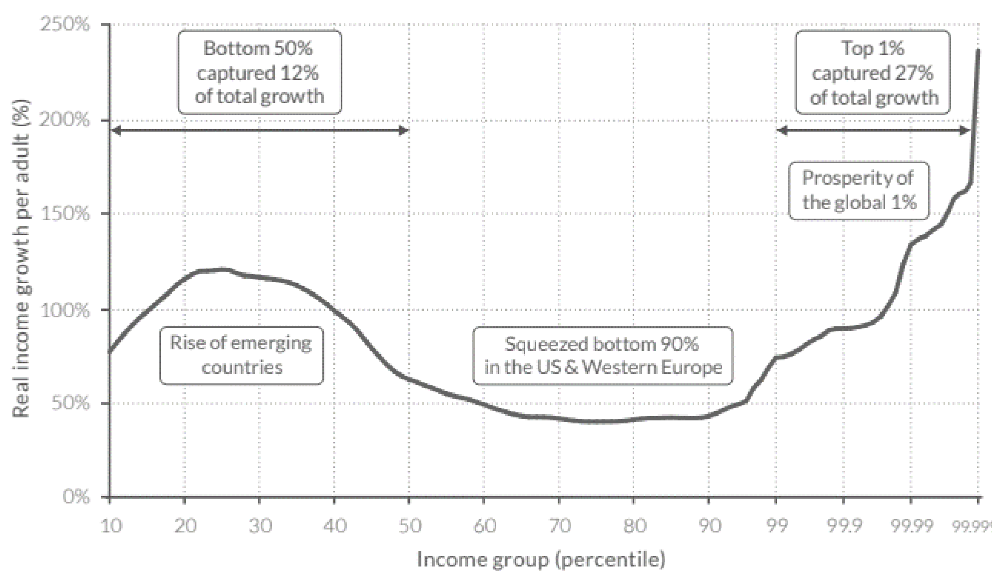


Megatrend #3

The Rising Gap between Rich and Poor

- Workers in many countries have not experienced any meaningful growth in real wages for years.
- Low or no real wage growth negatively affects aggregate demand and partially explains why GDP growth is so low everywhere.

Global Inequality



Megatrend #4

Rise of the East

- The first thing people spend more money on when living standards improve is more and better quality food – almost always more protein-rich food.
- In PPP terms, China has more middle class families now than the US.
- One should seek exposure to the growth in the Chinese economy without being exposed to the over-leveraged financial system in China.

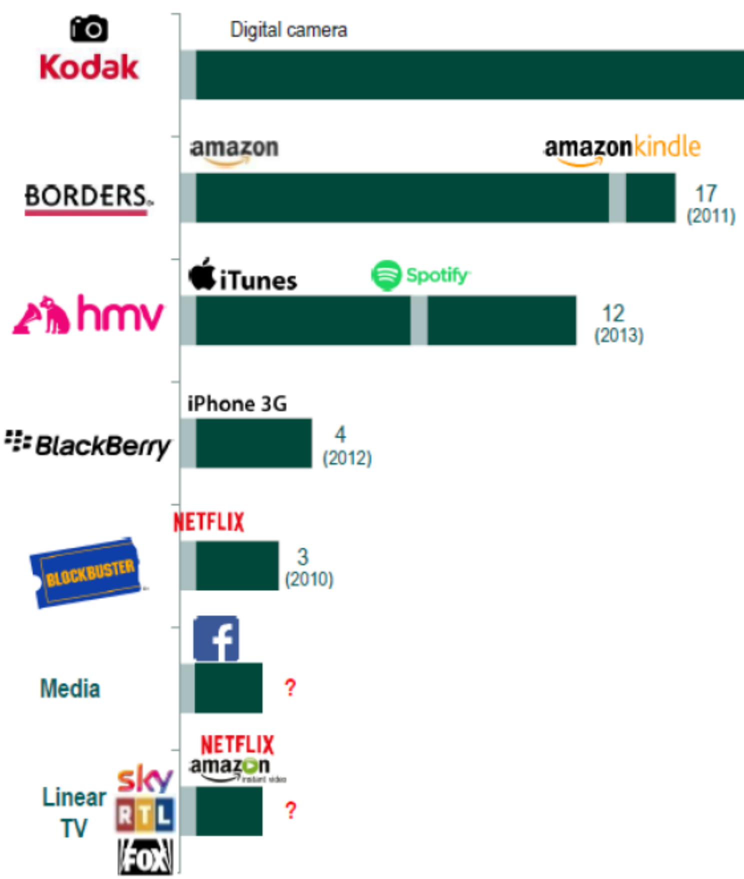
Chinese GDP Catch-Up under Various Assumptions

		Annual Chinese GDP Growth		
		3.00%	5.00%	7.00%
Annual US GDP Growth	1.00%	2047	2032	2027
	1.50%	2057	2034	2028
	2.50%	n/a	2041	2030

Megatrend #5

The Era of Disruption

No. of Years to Disrupt Incumbent's Businesses



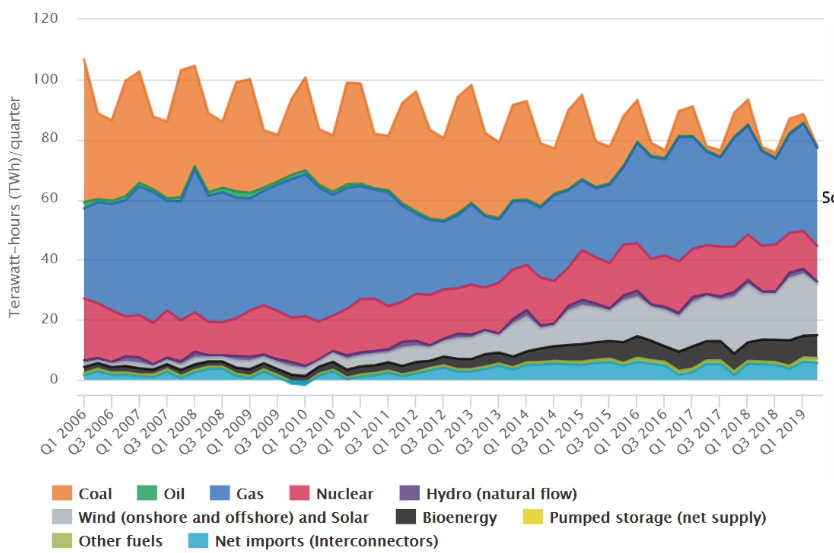
- Some disruptive businesses succeed whereas others don't. It is a misconception that entrants are disruptive by virtue of their success.
- Disruption is even more pronounced as a result of digitisation, but the disruption phenomenon is not at all limited to the technology industry.

Megatrend #6

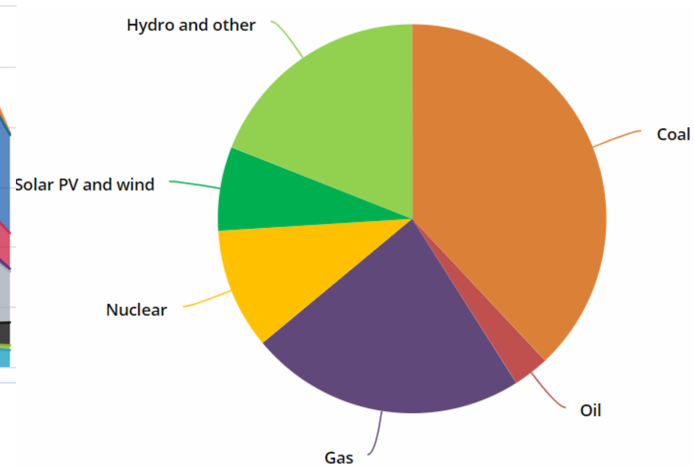
Climate Change

- Food production must rise 60% in the next 20 years to meet growing demand, and food production accounts for nearly 70% of all freshwater consumption globally.
- Despite countless promises, our political leadership is hopelessly behind on turning society carbon neutral by 2050.
- With climate change doing more an more damage, how will this play out?

UK Fuel Mix in Electricity Generation



Global Fuel Mix (2018)

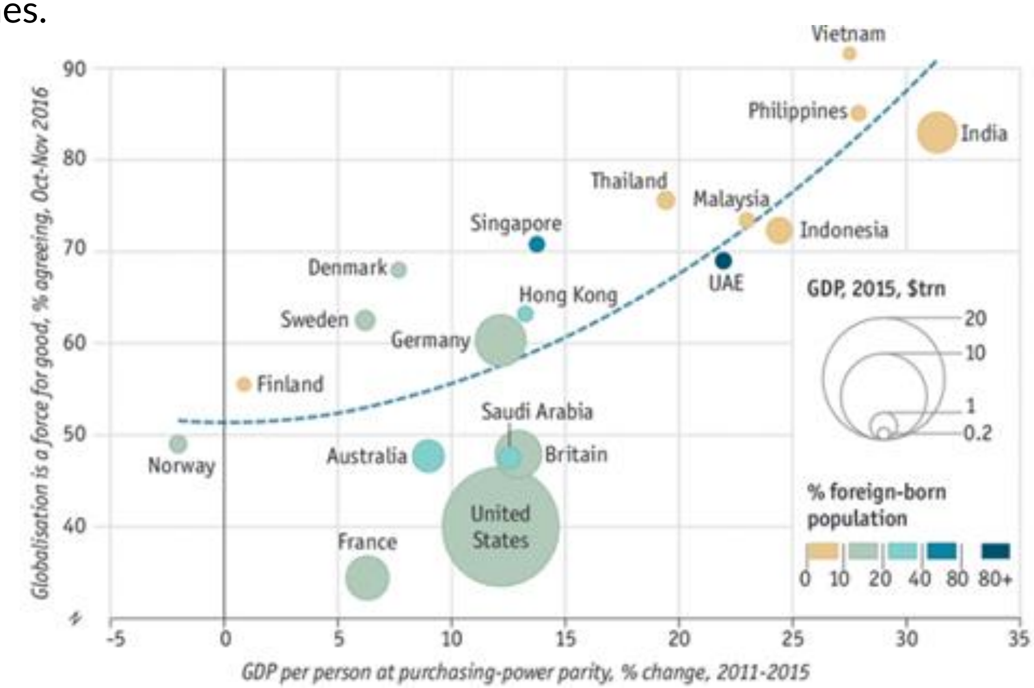


Megatrend #7

Globalisation 2.0

- From the height of the Global Financial Crisis in November 2008 to October 2016 some eight years later, protectionist measures adopted by members of the G20 reached a new all-time high of 5,560, and international trade started to slow as a result. WTO estimate that, in each of the last six years (2016-21), the volume of global trade in goods and services has grown below the growth rate of the global economy. This is otherwise unheard in post-WW II times.

- A new free trade agreement in Asia (RCEP) suggests that globalisation is not in reverse, but the parameters are most definitely changing. For example, in OECD countries, there is a rapidly growing appetite for importing less from rogue regimes whereas, in emerging markets, the appetite for more international trade is rising fast.



The aggregate result of those seven megatrends is not a very pleasant one.

Mean Reversion of Wealth-to-GDP

- Asset prices have grown much faster than GDP since the 1980s and, in the long run, one *cannot* outgrow the other.
- Every single time wealth has deviated meaningfully from its long-term mean value (c. 3.8x GDP in the US), it has regressed to the mean, and US wealth is now (as of early 2023) 5.65x US GDP.

Total US Household Wealth-to-GDP since 1951

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